

## Internal Revenue Service

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Department of the Treasury

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October 16, 2020

### Legend:

Taxpayer =

Operating =

Partnership

Company X =

Company Y =

Manager =

Joint Venture A =

Joint Venture B =

State A =

State B =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Year =

a =

b =

c =

d =

e =

f =

g =

h =

i =

Dear               :

This ruling responds to a letter dated April 10, 2020, and supplemental submissions, submitted on behalf of Taxpayer. Taxpayer requests a ruling regarding the treatment of Taxpayer's allocable share of management fees for purposes of the gross income tests under section 856(c)(2) and (3) of the Internal Revenue Code ("Code").

## FACTS

Taxpayer is a State A corporation. Taxpayer was formed on Date 1 and elected under section 856 to be a real estate investment trust ("REIT") beginning with its taxable year ended Date 2. Taxpayer expects to complete an initial public offering of its stock in the third quarter of Year.

Taxpayer conducts substantially all of its business through Operating Partnership, a State B limited liability company. Taxpayer owns the sole general partnership interest in Operating Partnership through its wholly owned subsidiary Company X, a State B limited liability company. Company X is a disregarded entity for federal income tax purposes. Taxpayer also directly owns a limited partnership interest in Operating Partnership. For federal income tax purposes, Operating Partnership is a disregarded entity.

Operating Partnership is the sole owner of Company Y, a State B limited liability company. Company Y elected to be treated as a corporation for federal income tax purposes. Company Y and Taxpayer jointly elected to treat Company Y as a taxable REIT subsidiary of Taxpayer. Company Y owns a percent of Manager, a State B limited liability company treated as a partnership for federal income tax purposes. Manager owns a small minority interest in Taxpayer (b percent as of Date 3). Manager's ownership interest is expected to change each quarter as Manager is paid a portion of its management fees in Taxpayer's common stock, but will not exceed c percent.

Operating Partnership's primary business is to acquire, invest in, and manage a portfolio of commercial real estate, multi-family residential properties, and mixed-use retail/residential properties (collectively, the "Properties"). Operating Partnership may occasionally acquire mortgage loans secured by commercial real estate and multi-family residential and commercial mixed-use retail/residential properties (collectively, the "Mortgages"). Additionally, and to a lesser extent, Operating Partnership will lend to investors via mezzanine debt that converts to preferred equity upon sale or refinancing (the "Mezzanine Debt") and may enter into sale-leaseback arrangements on certain properties (the "Leaseback Properties"). Operating Partnership will occasionally acquire the properties securing the Mortgages through foreclosure ("REO" and, together with the Properties, Mortgages, Mezzanine Debt, Leaseback Properties, the "Investments"). Operating Partnership does not expect foreclosure on REO very often.

In the ordinary course of business, Operating Partnership will receive interest and rental income from Investments ("Investment Income"). Taxpayer represents that substantially all of the Investment Income received by Taxpayer will be qualifying gross income under section 856(c)(2) and (3).

Operating Partnership may form joint ventures with unrelated third parties classified as partnerships for federal income tax purposes ("Joint Ventures"). Operating Partnership is currently a d-percent member in Joint Venture A and a e-percent member in Joint Venture B, which both hold commercial real estate assets. Taxpayer represents that Operating Partnership expects to own at least a f-percent interest in any future Joint Venture that owns Investments.

On Date 4, Manager entered into a management agreement with Taxpayer and Operating Partnership ("Management Agreement"). Pursuant to the Management Agreement, Manager (i) implements Operating Partnership's business strategy, (ii) manages Operating Partnership's business and investment activities and day-to-day activities and, (iii) provides Operating Partnership with a management team and necessary administrative and support personnel (the "Services"). Taxpayer represents that the Services provided by Manager will be usual and customary asset management services for the Investments. The Management Agreement provides that in the future, Manager may provide services to third parties under the condition that its Services to Taxpayer are not impaired. Manager does not currently provide services to any entities other than Operating Partnership. In the future, Manager may also provide Services to the existing Joint Ventures and other Joint Ventures, and will be compensated directly by the Joint Ventures.

Manager will not be the servicer of the Mortgages or provide any services to tenants. A third-party independent contractor will service the Mortgages and provide any necessary property management, lease management, and renovation management.

Manager is compensated through fees paid by Operating Partnership. For Manager's Services to Operating Partnership, Operating Partnership pays a base management fee and an incentive fee to Manager (the "Management Fees"). The base management fee is g percent of Taxpayer's consolidated stockholders' equity per annum. Taxpayer's consolidated stockholders' equity is the sum of the net proceeds from any issuances of equity by Taxpayer or Operating Partnership since inception, plus Taxpayer's and Operating Partnership's retained earnings less (i) any amount Taxpayer or Operating Partnership pays to repurchase its common stock or units since inception, (ii) any unrealized gains and losses and other non-cash items that have affected consolidated stockholder's equity, and (iii) any amount related to one-time events caused by changes in GAAP, and certain non-cash items not otherwise discussed above. The base management fee will be paid in a combination of cash and shares of Taxpayer's common stock.

The incentive fee will be payable quarterly in an amount equal to h percent of the dollar amount by which the sum of (A) aggregate cash dividends declared out of the REIT taxable income of Taxpayer and (B) distributions declared out of the taxable income of the Operating Partnership (without duplication) exceeds the product of i percent and the book value per share of Taxpayer's common stock as of the end of each quarter. The incentive fee is payable in cash.

Taxpayer intends to restructure its operations. Company Y will either distribute its a-percent interest in Manager to Operating Partnership or liquidate in a taxable or tax-free liquidation pursuant to section 331 or section 332. Thereafter, Operating Partnership will directly own the a-percent interest in Manager. Manager will continue to manage the Investments and be compensated as provided in the Management Agreement (as described above). Because Taxpayer (through disregarded Operating Partnership) will be a partner in Manager, Taxpayer will have gross income attributable to its share of the Management Fees.

Taxpayer represents that all activities Manager performs for Operating Partnership in exchange for Management Fees are activities that a REIT may, under the Code and the Income Tax Regulations (the "Regulations"), perform in managing the assets of the REIT as well as managing the REIT itself without adverse tax consequences. Taxpayer represents that it will treat its gross income attributable to any fees earned by Manager from third parties as non-qualifying income for purposes of section 856(c).

## LAW AND ANALYSIS

Section 856(c)(2) provides that, for a corporation to qualify as a REIT, at least 95 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from sources that include dividends; interest; rents from real property; gain from the sale or other disposition of stock, securities, and real property (including interests in real property); and abatement and refunds of taxes on real property.

Section 856(c)(3) provides that, for a corporation to qualify as a REIT, at least 75 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from sources that include rents from real property, interest on obligations secured by mortgages on real property or interests in real property, gain from the sale or other disposition of real property (including interests in real property), dividends from REIT stock and gain from the sale of REIT stock, and abatement and refunds of taxes on real property.

Section 856(c)(5)(J) provides that to the extent necessary to carry out the purposes of part II of subchapter M, the Secretary is authorized to determine, solely for purposes of such part, whether any item of income or gain which (i) does not otherwise qualify under section 856(c)(2) or (3) may be considered as not constituting gross income for purposes of section 856(c)(2) or (3), or (ii) otherwise constitutes gross

income not qualifying under section 856(c)(2) or (3) may be considered as gross income which qualifies under section 856(c)(2) or (c)(3).

Section 1.856-3(g) of the Regulations provides that a REIT that is a partner in a partnership is deemed to own its proportionate share of each of the assets of the partnership and is deemed to be entitled to the income of the partnership attributable to such share. For purposes of section 856, the interest of a partner in the partnership's assets is determined in accordance with the partner's capital interest in the partnership. The character of the various assets in the hands of the partnership and items of gross income of the partnership retain the same character in the hands of the partners as in the hands of the partnership for all purposes of section 856.

Section 1.856-4(b)(5)(ii) provides that the directors or trustees of a REIT are not required to delegate or contract out their fiduciary duty to manage the REIT itself, as distinguished from rendering or furnishing services to the tenants of the REIT's property or managing or operating the property. Thus, the trustees or directors may do all things necessary, in their fiduciary capacities, to manage and conduct the affairs of the trust itself. For example, the trustees or directors may establish rental terms, choose tenants, enter into and renew leases, and deal with taxes, interest, and insurance, relating to the REIT's property.

Section 61(a) of the Code provides that, except as otherwise provided, gross income includes all income from whatever source derived.

The legislative history underlying the tax treatment of REITs indicates that a central concern behind the gross income restrictions is that a REIT's gross income should largely be composed of passive income. For example, H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-23 states, "[o]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business."

After the restructuring, Operating Partnership will (a) earn Investment Income from Investments, (b) pay Management Fees to Manager, and (c) be allocated a percent of those Management Fees for purposes of section 856(c) as a a-percent partner in Manager. Because Taxpayer owns 100 percent of Operating Partnership, 100 percent of the Management Fees represent an expense of Taxpayer for services to Taxpayer. Taxpayer will therefore include gross income attributable to both the Investment Income and the Management Fee income. Because the Management Fees are derived from the same Investments that generate the Investment Income, including Taxpayer's share of the Management Fees in Taxpayer's gross income would cause the amounts to be counted twice for purposes of the gross income tests under section 856(c). Moreover, Taxpayer's gross income attributable to Manager's Management Fee income represents an amount that Taxpayer, as a partner in Manager, is charging itself to perform functions that, based on Taxpayer's representations, Taxpayer could perform directly without adverse tax consequences. Under these circumstances, excluding

Taxpayer's share of the Management Fees from Taxpayer's gross income for purposes of section 856(c)(2) and (3) is consistent with the purposes of part II of subchapter M.

### CONCLUSION

Based on the facts submitted and representations made by Taxpayer, Taxpayer's gross income attributable to its allocable share of the Management Fees will be treated under section 856(c)(5)(J) as not constituting gross income for purposes of section 856(c)(2) or (3).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed or implied as to whether Taxpayer otherwise qualifies as a REIT; whether the Investment Income is qualifying REIT income under section 856(c)(2) or (3); whether the REOs qualify as foreclosure property; whether the sale of any REO is a prohibited transaction under section 857(b)(6); or whether any of Manager's activities under the Management Agreement are activities the REIT may perform itself without adverse tax consequences.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

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Steven Harrison  
Branch Chief, Branch 1  
Office of Associate Chief Counsel  
(Financial Institutions and Products)

cc: